

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street
San Francisco, California 94105**

**NOTICE OF PROPOSED EMERGENCY READOPTION
PURSUANT TO CALIFORNIA INSURANCE CODE SECTION 12921.7**

**Consideration of Losses and Loss Exposure
In Residential Property Insurance Rating and Underwriting**

File No. ER04041299

November 2, 2004

This regulation supersedes the Advisory Notice entitled “Eligibility Guidelines and the Use of Loss Information by Residential Property Insurers” dated June 25th 2004.

California Insurance Commissioner John Garamendi (the Commissioner) hereby provides notice pursuant to California Insurance Code §12921.7 that he will submit for readoption Title 10, Chapter 5, Subchapter 3, Article 7.2, §2361 of the California Code of Regulations (Cal. Code Regs., tit. 10, §2361) to the Office of Administrative Law for approval pursuant to California Government Code §11346.1(h).

The emergency regulations (10 CCR §2361) implement and make specific California Insurance Code §§791.02, 1857, and 1861.05.

This Notice includes an **updated** description of the problem the regulations are intended to resolve, an explanation of the justification for the adoption of the emergency regulations, and a copy of the text of the emergency regulations.

The Notice will be provided to every person, group, and association who has previously filed a request for notice of all regulatory actions with the Commissioner, as well as to every person, group, and association having filed a request to receive only notices of regulations specifically involving Property and Casualty insurance. Copies of the Notice, and the text of the regulations, are available at the Department of Insurance, 45 Fremont Street, 21st Floor, San Francisco, California 94105, as well as on the Department’s “Proposed Regulations” web page, accessible at:
<http://www.insurance.ca.gov/docs/FS-Legal.htm>.

The regulation will be submitted to the Office of Administrative Law not less than five (5) working days after the mailing of this Notice. Questions regarding this rulemaking action should be directed to: Donald P. Hilla, Senior Staff Counsel, Department of Insurance, 45 Fremont Street, 21st Floor, San Francisco, CA 94105, hillad@insurance.ca.gov. Electronic submissions are encouraged but should be accompanied by hardcopy submissions.

Description of Problem and Necessity for Regulations

Under California law an insurer may not base underwriting decisions solely on information gathered from insurance-support organizations, without obtaining further personal information from the insured. (Ins. Code §791.12(b).) Under California law an insurer may not refuse to issue a policy for homeowners insurance under conditions less favorable to the potential insured than to other comparable, potential insureds. (Ins. Code §679.71) Under California law underwriting plans and eligibility guidelines may not be arbitrary or unfairly discriminatory. (Ins. Code §§1861.03, 1861.05(a); Cal. Code Regs., tit. 10, §2360.0 et seq.) Under California Law, during the prior approval process, the Commissioner may consider rating manuals, rating plans, underwriting rules and eligibility guidelines, and any other information that may be required. (Cal. Code Regs., tit. 10, §2643.3(b), 2648.4 and Ins. Code §§1857, 1857.2, 1857.3, 1857.7, 1857.9, 1864 and 1861.05(b).) Additionally, pursuant to this regulation, insurers must maintain documentation to allow CDI to determine compliance with the law. (Ins. Code §1857.)

Despite these prohibitions, the California Department of Insurance (“CDI”) continues to receive numerous complaints from policyholders who have had their insurance coverage cancelled or not renewed for the act of making a claim or for simply making an inquiry about coverage. CDI also has received voluminous complaints from policyholders that have been denied coverage or had coverage terminated due to insurance companies relying solely on insurer-support organization databases that have been shown to rely on and contain incomplete or erroneous loss history data. CDI has received complaints that an insurer cancelled a policy after a policyholder filed a claim for water damage caused by a leaky roof, even though the roof was subsequently replaced, making the risk of future loss negligible. This regulation makes it clear that such practices are not permissible. CDI has also received complaints from policyholders that were unable to obtain coverage as a result of information contained in Comprehensive Loss Underwriting Exchange (CLUE) reports despite the fact that the information was incorrect. Pursuant to this regulation, as required by Ins. Code §791.12, an insurer must verify specified information before it can be used as the basis for an adverse underwriting decision.

While there are laws specific to insurance rating and underwriting that address cancellation, nonrenewal and eligibility for homeowners insurance, both the insurance industry and the insurance consuming public are unclear as to the exact application of these laws. This regulation clarifies and makes specific the application of these laws in California. Specifically, this regulation clarifies and makes specific the interaction of existing law governing homeowners insurance underwriting and rating.

A significant number of Californians found it impossible to purchase insurance, or had their insurance cancelled or not renewed due to an insurer’s cancellation, nonrenewal and underwriting rules, in noncompliance with California law. This crisis was evidenced in the startling increase in the number of consumer complaints received by CDI and by

scores of media reports on the lack of availability of homeowners policies and the impact on not only consumers but also the real estate and financial industries.

The Commissioner recognized the growing problem and attempted to resolve the situation by working with individual insurers and by communicating to the industry as a whole. These efforts were met with a lawsuit challenging the Commissioner's authority to enforce the insurance laws. (American Insurance Association; Association of California Insurance Companies; Personal Insurance Federation of California v. John Garamendi, Superior Court of the State of California, County of Sacramento, Case No. 03CS00839.) The Court's preliminary conclusion and ruling was that the Commissioner's communication with the industry should have been accomplished through, or pursuant to, the Administrative Procedure Act.

This matter is currently on appeal to the Court of Appeal of the State of California in and for the Third Appellate District (Court of Appeal Number C045000).

On or around September 16, 2004 counsel for the California Department of Insurance were notified by the Court of Appeal that oral argument in this matter would take place on October 18, 2004. On or around September 21, 2004 Respondents, American Insurance Association, petitioned the Court of Appeal for a continuance, or postponement of oral argument. The request was based on the vacation schedule of counsel for AIA. This scheduling conflict would make counsel unavailable for oral argument until November 22, 2004, at the very earliest. CDI opposed the request. The court of Appeal granted the request. Oral argument on the matter is now scheduled for December 20, 2004.

The request for continuance is remarkable because the current emergency regulation expires on November 10, 2004 and counsel for AIA would not be available for oral argument until November 22, 2004. In essence, the request for continuance made by AIA has the practical effect of mooting out the controversy that is the basis of the appeal unless CDI requests and OAL grants a readoption of the regulation on an emergency basis.

CDI had hoped to avoid making such a request and was planning instead to have its day in court before the expiration of the current emergency regulation on November 10, 2004. CDI intended to petition the court for an expedited ruling before the expiration of the current emergency regulation. Due to the changes in schedule as described CDI is now in the position of having to request a readoption of the emergency regulation. If regulation is not readopted the case now before the Court of Appeal will be moot.

Many hundreds of hours of work have been done by attorneys for both sides to get to this critical juncture in the litigation. The record in the case is in the thousands of pages. An unknown number of taxpayer and insurance consumers' dollars have been spent in an effort to establish the legitimacy (or illegitimacy) of this regulation. The questions before the court are far reaching, profoundly impacting the insurance consumers of this state.

As litigation in this matter is still pending, the emergency regulations must be extended for an additional 120 days. It is imperative that if the matter is favorably resolved, that the Department be able to immediately enforce the emergency regulations pending completion of the permanent rulemaking process.

Justification for Adoption of Emergency Regulations

During the course of the lawsuit challenging the Commissioner's authority to enforce the insurance laws, insurance industry trade groups claimed the industry was confused regarding the interpretation and interrelationship of the various applicable statutes and regulations. This regulation was designed to comply with the judge's order and to eliminate confusion regarding the implementation of existing law.

As the homeowners insurance market continued to show signs of stress and insurers perpetuate "use it and lose it" underwriting rules (whereby the filing of a claim or even a coverage inquiry results in cancellation of an insurance policy), the Commissioner believed immediate rulemaking action was necessary to protect the health, safety and welfare of California consumers.

An emergency regulation was the only way the Commissioner could immediately protect the health, safety and welfare of the insurance consumers of this state.

CDI experienced an unprecedented increase in complaints from consumers regarding homeowners insurance issues. These complaints related to cancellation, nonrenewal and eligibility in homeowners insurance lines.

Throughout 2001, CDI received only 318 formal complaints regarding homeowners insurance. In contrast, by the third quarter of 2002, CDI had received 1,200 written complaints from consumers, making the subject of homeowners insurance the number one consumer complaint issue in Property and Casualty lines at the Department of Insurance. CDI continues to receive an inordinate number of complaints on this issue.

The Commissioner believes that the unprecedented increase in the number of complaints relating to cancellation, nonrenewal, and unavailability of homeowners insurance evidenced a homeowners insurance availability crisis in California. The repercussions of such a crisis threaten immediate harm in the real estate and financial markets and threaten to further undermine an already fragile California economy. A crisis of this kind also has an immediate and profound effect on the consumers of this state who may be unable to either purchase or sell a home or who upon cancellation may be involuntary transferred into the costly residual or forced-place insurance markets.

The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." The Commissioner is charged with enforcing Proposition

103 and all other Insurance Code provisions. With the growing availability crisis, the Commissioner believes proposing this regulation on an emergency basis is necessary to ensure homeowners insurance remains available in California.

As a result of Superior Court Judge Raymond M. Cadei's order it became necessary for the Commissioner to adopt a regulation on an emergency basis to implement, interpret and make specific the California insurance laws as they relate to homeowners insurance. As this matter is currently pending in the Court of Appeal in and for the Third Appellate District, the emergency regulations need to be readopted in order to remain effective during the pending appeal and subsequent promulgation of permanent regulations.

Updated Justification for Adoption of Emergency Regulations

The Continuing Emergency: Consumer Complaints

As of the date of this Notice insurance consumers in California continue to face major issues relating to the residential insurance market. Complaints continue to pour into CDI relating to cancellations and non-renewals, refusals to insure, and premium increases based on claims and the improper use of insurance-support organization claims history reports.

As stated previously, in 2003 written complaints increased threefold over the 2001 and 2002 calendar years. The number of complaints received from January, 2004, through June 16, 2004, would indicate at least a 100% increase in complaints as compared to 2001.

Clearly, the crisis in homeowners insurance availability continues in California impacting the health, safety and welfare of all Californians.

Southern California Firestorms / Cancellations and Non-renewals

The Commissioner has personally visited areas in Southern California devastated by firestorms which raged through Southern California in late 2003. While it is too soon to provide detailed statistical evidence for the rulemaking file, anecdotal evidence points toward several trends which will act to exacerbate the insurance availability crisis in California.

"Use It and Lose It"

Since October of 2003 over 110 people in San Diego have filed written complaints with CDI relating to cancellation and nonrenewal

Some fire victims who did not suffer total losses as a result of the firestorm have been non-renewed by their insurers and have had difficulty in procuring insurance due to their having made claims. Other victims who suffered total losses who have purchased homes in other areas instead of rebuilding on their old lots have experience trouble procuring

insurance coverage because they made claims. Some victims who have settled their claims with insurers and have begun the rebuilding process have had difficulties finding coverage due to claims made resulting from the wildfires.

Some insurers have cancelled or non-renewed coverage where the insured suffered a total loss citing Insurance Code section 676(c). These victims have voiced concern regarding their ability to get coverage later after they rebuild. Some have been told by their agents insurance from their former insurers will not be available.

Tightening Underwriting Standards

There is other anecdotal evidence that indicates many California Insurers are tightening underwriting guidelines in order to lessen their exposure in what are considered by the industry to be “high-risk” or “brush” areas. The Commissioner believes these new underwriting standards are and will continue to have a profound effect on the residential property insurance market in California.

Conclusion

For these reasons and for reasons to be discussed in detail in the upcoming notice the Commissioner has determined there exists continued justification for promulgation of this regulation on an emergency basis.

Text of the Proposed Regulations to be Adopted

The proposed regulation text is attached.